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No. 96-1075

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IN THE
Supreme Court of the United States
OCTOBER TERM, 1996

ERNST & YOUNG LLP,
Petitioner,
v.
DOLLARD MCGANN, ON BEHALF OF HIMSELF AND ALL OTHERS SIMILARLY SITUATED, *et al.*,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* AND BRIEF OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* IN SUPPORT OF PETITIONER

The American Institute of Certified Public Accountants (the "Institute") hereby respectfully moves for leave to file the attached brief as *amicus curiae* in this case. The consent of Petitioner, Ernst & Young LLP, was obtained.[1] The consent of the Respondents, Dollard McGann *et al.*, was requested but refused.

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[1] The written consent was filed with the Clerk of the Court.

The Institute is the national organization of the certified public accounting profession, with more than 325,000 members. The Institute develops authoritative accounting, auditing, and ethical standards of practice, including ones which, in conjunction with SEC rules, govern independent auditors in reporting on a company's financial statements in publicly filed disclosure documents.

The Institute has a long-standing interest in the scope and bases of civil liability sought to be imposed on accountants under the federal securities laws. The Institute's predecessor, the American Institute of Accountants, participated in the legislative efforts leading to the Securities Exchange Act of 1934. The Institute also has participated as *amicus curiae* in numerous cases before this Court addressing liability under the judicially implied Section 10(b) private right of action.[2]

The Petitioner argues several grounds supporting the grant of *certiorari*. The brief that the Institute seeks leave to file as *amicus curiae* joins those arguments but addresses more broadly the implications that the Ninth Circuit's ruling may have on accountants and others if allowed to stand. In particular, the decision below exposes accountants to potential Section 10(b) liability every time they provide an audit report to management of a publicly traded company. Because SEC rules *require* that audit reports be included in public disclosure documents, the Ninth Circuit's ruling will have far-reaching, adverse effects on the provision of these vital accounting services to issuers of securities. The Institute's brief argues that such expansive liability cannot be squared with the plain language of Section 10(b) or the express right of

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[2] The cases include *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439 (1994); *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286 (1993); *Basic Inc. v. Levinson*, 485 U.S. 224 (1988); *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979); and *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

action provided by Congress in Section 18 for false statements made by accountants and others in publicly filed disclosure documents.

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QUESTIONS PRESENTED

1. Whether an independent auditor "use[s] or employ[s]" fraud "in connection with" the purchase or sale of a security, and thus becomes liable for a primary violation of Section 10(b), merely by providing an allegedly misleading audit report to a client, which the client later includes in a routine Form 10-K filing with the SEC?

2. Whether the "in connection with" clause can be read so broadly as to allow plaintiffs to bring "fraud-on-the-market" claims under the implied Section 10(b) action against accountants for allegedly misleading audit reports in an SEC filing, when Congress imposed an actual reliance requirement in creating the express Section 18 action for precisely the same alleged misconduct?

TABLE OF CONTENTS

	Page
QUESTIONS PRESENTED	i
TABLE OF AUTHORITIES	v
PRELIMINARY STATEMENT	1
INTEREST OF THE INSTITUTE AS *AMICUS CURIAE*	1
STATEMENT OF THE CASE	3
REASONS FOR GRANTING THE WRIT	4
I. THE DECISION BELOW CREATES AN IRRECONCILABLE CONFLICT BETWEEN THE IMPLIED SECTION 10(b) AND EXPRESS SECTION 18 ACTIONS IN THE POST-*CENTRAL BANK* ERA	4
A. The *Texas Gulf* Foreseeability Approach	5
B. The *Texas Gulf Foreseeability* Approach Allows Plaintiffs To Evade Section 18's *Actual Reliance* Requirement	5
C. The *Texas Gulf* Foreseeability Approach Is As Firmly Entrenched As Aiding And Abetting Liability Was Before *Central Bank*	8
II. THE DECISION BELOW UNDERMINES *CENTRAL BANK* BY ADHERING TO AN INTERPRETATION OF SECTION 10(b) THAT MAKES NO MEANINGFUL DISTINCTION BETWEEN "PRIMARY" AND "SECONDARY" LIABILITY UNDER THE STATUTE	9
A. The Independent Auditor's Role Is Secondary To That Of The Client	10

TABLE OF CONTENTS—Continued

Page

B. The Independent Auditor's Liability Properly Lies Under Section 18 11

III. THE QUESTIONS PRESENTED BY THE PETITION WARRANT THE IMMEDIATE ATTENTION OF THIS COURT 12

CONCLUSION 13

TABLE OF AUTHORITIES

CASES — Page

Adam v. Silicon Valley Bancshares, 884 F. Supp. 1398 (N.D. Cal. 1995) 8
Akin v. Q-L Invs., Inc., 959 F.2d 521 (5th Cir. 1992) 8
Basic Inc. v. Levinson, 485 U.S. 224 (1988) 7
Bily v. Arthur Young & Co., 834 P.2d 745 (Cal. 1992) 10
Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) 13
Britt v. Cyril Bath Co., 417 F.2d 433 (6th Cir. 1969) 8
Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 114 S. Ct. 1439 (1994) ..... *passim*
City Nat'l Bank of Fort Smith, Ark. v. Vanderboom, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970) 8
Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) 6, 8
Gottlieb v. Sandia Am. Corp., 452 F.2d 510 (3d Cir.), *cert. denied*, 404 U.S. 938 (1971) 8
Gross v. Diversified Mortgage Investors, 438 F. Supp. 190 (S.D.N.Y. 1977) 7
Herman & MacLean v. Huddleston, 459 U.S. 375 (1983) 8
Itoba Ltd. v. Lep Group PLC, 54 F.3d 118 (2d Cir. 1995), *cert. denied*, 116 S. Ct. 703 (1996) 8
Kehr v. Smith Barney, Harris Upham & Co., 736 F.2d 1283 (9th Cir. 1984) 12
In re M.D.C. Holdings Sec. Litig., 754 F. Supp. 785 (S.D. Cal. 1990) 7
Musick, Peeler & Garrett v. Employers Ins. of Wausau, 508 U.S. 286 (1993) 8
Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978) 12
SEC v. Savoy Indus., 587 F.2d 1149 (D.C. Cir. 1978), *cert. denied*, 440 U.S. 913 (1979) 8
SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied sub nom.* 394 U.S. 976 (1969) 3, 5

TABLE OF AUTHORITIES—Continued

	Page
Touche Ross & Co. v. Redington, 442 U.S. 560 (1979)	6
Wessel v. Buhler, 437 F.2d 279 (9th Cir. 1971)	8
STATUTES	
15 U.S.C. § 78j (1994)	*passim*
15 U.S.C. § 78r (1994)	*passim*
RULES	
17 C.F.R. § 210.2-01(b) (1996)	11
17 C.F.R. pt. 249 (1996)	2
LEGISLATIVE MATERIALS	
78 Cong. Rec. 8040 (1934)	6
S. 2693, 73d Cong., 2d Sess., § 17(a) (1934)	6
OTHER AUTHORITIES	
Codification of Auditing Standards and Procedures, Statement on Auditing Standards No. 1, § 110.02 (AICPA 1994)	10, 11
Codification of Auditing Standards and Procedures, Statement on Auditing Standards No. 1, § 220 (AICPA 1994)	11

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BRIEF OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS *AMICUS CURIAE*

PRELIMINARY STATEMENT

The American Institute of Certified Public Accountants (the "Institute") submits this brief as *amicus curiae*, pursuant to Rule 37.3 of the Rules of this Court.

INTEREST OF THE INSTITUTE AS *AMICUS CURIAE*

The Institute and its members are vitally interested in the questions presented.[1] SEC rules require that an audit

[1] The Institute also filed an *amicus* brief in *United States v. O'Hagan*, No. 96-842, which raises the proper meaning and application of the "use or employ . . . in connection with" requirement in the misappropriation context. The Institute is serving copies of this brief on the *O'Hagan* parties.

report prepared by independent auditors be included in Form 10-Ks and other routine disclosure documents. *See* 17 C.F.R. pt. 249 (1996).[2] Publicly traded companies cannot satisfy their reporting obligations without the services of an independent auditor. Even so, the auditor's role is secondary to that of the client. The client is responsible for the financial statements and other information contained in a disclosure document.

The Ninth Circuit wrongly held that an independent auditor "use[s] or employ[s]" fraud "in connection with" the purchase or sale of a security under Section 10(b) merely by providing an allegedly misleading audit report to a client, who then places it in a required Form 10-K filing. *Pet. App.* at 16a-17a. Although the auditor may *make* an allegedly false statement in an audit report, the auditor surely does not *use or employ* that statement *in connection with* a securities transaction merely by providing the audit report to the client.

The Ninth Circuit's decision fails to give proper effect to the plain words of Section 10(b). The decision also conflicts with the express right of action under Section 18, which imposes civil liability on accountants and others who *make* false statements in publicly filed disclosure documents. If allowed to stand, the decision will erode any meaningful distinction between "primary" and "secondary" liability under Section 10(b), and will allow strike-suit plaintiffs to ensnare accountants and other perceived "deep pocket" professionals in the very kind of vexatious litigation that this Court warned against in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439, 1454 (1994).

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[2] The number of disclosure filings requiring audit reports continues to grow expansively, as the number of issuers and the volume of securities trading increase. For example, approximately 11,160 annual reports were filed with the SEC in 1993, the year *Central Bank* was heard. In 1996, approximately 12,725 annual reports were filed, an increase of roughly 15 percent. The number of other SEC-required filings also has increased proportionally.

STATEMENT OF THE CASE

Respondents are representatives of a class of purchasers of common stock of Community Psychiatric Centers ("CPC") between September 1990 and November 1991. *Pet. App.* at 4a. They allege that Ernst & Young prepared a false and misleading audit report that failed to disclose a major accounts receivable problem. The audit report was included by CPC's management in an annual Form 10-K for 1990. *Id.* at 19a. Respondents claim that the misleading audit report artificially inflated CPC's stock, that they purchased their shares before the accounts receivable problem was disclosed, and that they lost money upon the disclosure when the value of the stock declined. *Id.* at 3a-4a.

The district court, relying on *Central Bank,* held that the mere submission of an allegedly false audit report to a client, with knowledge that it will be included by the client in its annual Form 10-K, does not satisfy the "use or employ . . . in connection with" requirement of Section 10(b). *Id.* at 30a-33a. The Ninth Circuit reversed. The Ninth Circuit found that *Central Bank* did not overrule the Second Circuit's nearly thirty year-old decision in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied sub nom.* 394 U.S. 976 (1969), which held that the "use or employ . . . in connection with" requirement is satisfied whenever an allegedly false or misleading statement is *made* "in a manner reasonably calculated to influence the investing public . . . ." *Pet. App.* at 15a. Because Ernst & Young knew that the allegedly false audit report would be included by CPC in its Form 10-K, the court ruled that Ernst & Young is potentially liable under Section 10(b), even though Ernst & Young did not "use or employ" the allegedly false audit report "in connection with" any particular securities transaction. *Id.* at 17a. Indeed, there is no allegation that Ernst & Young had any knowledge of, interest in, or involvement with the Respondents' particular trades.

REASONS FOR GRANTING THE WRIT

I. THE DECISION BELOW CREATES AN IRRECONCILABLE CONFLICT BETWEEN THE IMPLIED SECTION 10(b) AND EXPRESS SECTION 18 ACTIONS IN THE POST-*CENTRAL BANK* ERA.

The *Central Bank* decision overruled three decades of lower court cases imposing aiding and abetting liability under Section 10(b). In so ruling, the Court noted that traditional "secondary" actors in securities transactions, such as accountants and lawyers, remain potentially liable under Section 10(b), but only where "*all* of the requirements for primary liability under Rule 10b-5 are met." *Central Bank*, 114 S. Ct. at 1455 (emphasis in original).

Central Bank predictably has focused attention on the meaning of the "*use or employ . . . in connection with*" requirement and the scope of conduct it encompasses, as class action plaintiffs—like Respondents—seek to convert aiding and abetting claims into "primary" Section 10(b) claims against accountants and other traditional "secondary" actors. The case below poses, in as simple and direct a factual setting as one can envision, the question of how broadly the "use or employ . . . in connection with" requirement can be reasonably interpreted when determining the type of conduct that constitutes a primary violation of Section 10(b).

The Ninth Circuit answered that question by ignoring the plain words of the statute and by adhering instead to the broad "foreseeability" approach formulated nearly thirty years ago in *Texas Gulf*. The overly broad *Texas Gulf* approach was largely inconsequential when accountants and other secondary actors could be held liable under Section 10(b) as aiders and abettors. After *Central Bank*, however, the *Texas Gulf* "foreseeability" test creates an impermissible conflict in the federal securities laws that cannot be reconciled with this Court's precedents.

A. The *Texas Gulf* Foreseeability Approach.

Texas Gulf was an SEC enforcement action brought against a company and several insiders for issuing allegedly misleading press releases about the prospects of some drilling operations. 401 F.2d at 842. The trial court dismissed the SEC's claims, holding that the allegedly misleading statements in the press releases were not made "in connection with" the purchase or sale of a security. *Id.*

The Second Circuit reversed. The court held that the *congressional purpose* underlying Section 10(b) would be better served by looking beyond the express words used by Congress—which plainly require some purposeful connection between a defendant's own conduct and the purchase or sale of a security—to reach instead any fraudulent statement by any person that is made "in a manner reasonably calculated to influence the investing public." *Id.* at 858-62.

Texas Gulf thus substitutes a broad *foreseeability* standard, akin to that for fraudulent misrepresentations under common law, for the actual words used in Section 10(b); namely, that a defendant "use or employ" a false statement "in connection with the purchase or sale of any security." If it is foreseeable that an actor's statements may somehow, somewhere influence a potential investor, the actor is subject to Section 10(b) liability, *regardless* of whether the actor actually *used or employed* the misrepresentation *in connection with* an identifiable securities trade.

B. The *Texas Gulf* Foreseeability Approach Allows Plaintiffs To Evade Section 18's *Actual Reliance* Requirement.

The decision below demonstrates how the broad *Texas Gulf* foreseeability approach allows plaintiffs to bring suit under an implied Section 10(b) claim for conduct expressly targeted by Congress under Section 18. Section

18 imposes liability against any person who *makes* a fraudulent statement in a Form 10-K or other required SEC filing that affects the price of a security.[3] This is *precisely the same conduct alleged against Ernst & Young below* in the guise of a primary violation of Section 10(b).

Section 18 was enacted contemporaneously with Section 10(b) and the public disclosure requirements of the 1934 Act. Section 18 also was identified by Congress as the provision creating civil liability for any false or misleading statements made by accountants or others in reports required under the new disclosure scheme. *See generally* 78 Cong. Rec. 8040 (1934).[4]

The overlap of potential liability under Sections 10(b) and 18 created by *Texas Gulf* results in an irreconcilable conflict between the two statutes. Section 18 requires actual "eyeball" reliance. The original draft of Section 18 would have allowed recovery by any plaintiff "who shall have purchased or sold a security the price of which may have been affected by [the allegedly fraudulent] statement." S. 2693, 73d Cong., 2d Sess., § 17(a)

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[3] Section 18 states, in pertinent part, that:

> Any person who shall make or cause to be made any statement in any . . . document filed pursuant to this chapter or any rule or regulation thereunder . . . which statement was . . . false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement . . . unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading.

15 U.S.C. § 78r (1994).

[4] This Court has reserved the question of whether Section 18 is an exclusive remedy for false statements made in reports filed with the SEC. *Touche Ross & Co. v. Redington*, 442 U.S. 560, 573 (1979). *See also Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 211 n.31 (1976).

(1934). As explained by Justices O'Connor and White in their dissent in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), this original draft of Section 18:

> would have permitted suits by plaintiffs based solely on the fact that the price of the securities they bought or sold was *affected by a misrepresentation*: a theory closely akin to [fraud-on-the-market]. Yet, this provision was roundly criticized in congressional hearings on the proposed Securities Exchange Act, because it failed to include a more substantial "reliance" requirement. Subsequent drafts modified the original proposal, and included an *express reliance requirement* in the final version of the Act.

Id. at 257-58 (emphasis added) (citations omitted). Section 18 thus reflects a careful balance struck by Congress to promote the goals of accurate financial reporting without exposing accountants and others involved in public filings to overly expansive liability for their statements.

In contrast, the implied Section 10(b) action, as interpreted by this Court, does *not* require actual reliance, but permits plaintiffs to proceed under the lesser "fraud-on-the-market" reliance theory. *Id.* at 241-50. Under this theory, Section 10(b) plaintiffs can proceed without pleading or proving actual reliance. The same claims would fail under Section 18 for lack of actual reliance.[5] Because the broad *Texas Gulf* foreseeability approach allows conduct expressly proscribed by Section 18 to be pleaded as a "fraud-on-the-market" under Section 10(b), there is no case where a plaintiff cannot evade the actual reliance requirement imposed by Congress in Section 18.

This Court has held that the implied Section 10(b) action cannot be extended so far that it allows causes of

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[5] *See, e.g., In re M.D.C. Holdings Sec. Litig.*, 754 F. Supp. 785 (S.D. Cal. 1990) (dismissing Section 18 claims alleging "fraud-on-the-market" reliance); *Gross v. Diversified Mortgage Investors*, 438 F. Supp. 190 (S.D.N.Y. 1977) (dismissing Section 18 claims alleging similar "constructive" reliance theory).

action under the express remedies "to be brought instead under § 10(b), 'thereby nullify[ing] the effectiveness of the carefully drawn procedural restrictions on these express actions.'" *Herman & MacLean v. Huddleston*, 459 U.S. 375, 384 (1983) (citations omitted). *See also Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 291-93 (1993) (implied Section 10(b) action cannot be interpreted to conflict with Congress's own express rights of action); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 210 (1976) (same). The Ninth Circuit's decision below violates this fundamental tenet. By adhering to *Texas Gulf*'s broad foreseeability approach, the Ninth Circuit's ruling will permit plaintiffs to side-step the actual reliance requirement of Section 18 *in all cases*, rendering this important restriction a complete nullity.

C. The *Texas Gulf* Foreseeability Approach Is As Firmly Entrenched As Aiding And Abetting Liability Was Before *Central Bank*.

Texas Gulf's broad foreseeability approach has been widely adopted by the lower courts and is as entrenched in the federal case law as aiding and abetting liability was before *Central Bank*.[6] Despite this Court's repeated pronouncements on the proper analysis of the implied Section 10(b) action, the decision below and other post-*Central Bank* cases show no signs of retrenchment by the lower courts from *Texas Gulf*'s policy-based approach. *See, e.g., Adam v. Silicon Valley Bancshares*, 884 F. Supp. 1398, 1402 (N.D. Cal. 1995); *Itoba Ltd. v. Lep Group PLC*, 54 F.3d 118, 123 (2d Cir. 1995), *cert. denied*, 116 S. Ct. 703 (1996). There is little doubt, then, that

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[6] *See, e.g., Akin v. Q-L Invs., Inc.*, 959 F.2d 521 (5th Cir. 1992); *SEC v. Savoy Indus.*, 587 F.2d 1149 (D.C. Cir. 1978), *cert. denied*, 440 U.S. 913 (1979); *Gottlieb v. Sandia Am. Corp.*, 452 F.2d 510 (3d Cir.), *cert. denied*, 404 U.S. 938 (1971); *Wessel v. Buhler*, 437 F.2d 279 (9th Cir. 1971); *City Nat'l Bank of Fort Smith, Ark. v. Vanderboom*, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); *Britt v. Cyril Bath Co.*, 417 F.2d 433 (6th Cir. 1969).

the impermissible conflict between the Section 10(b) and Section 18 actions created by *Texas Gulf* will continue unabated unless and until this Court takes up the issue.

II. THE DECISION BELOW UNDERMINES *CENTRAL BANK* BY ADHERING TO AN INTERPRETATION OF SECTION 10(b) THAT MAKES NO MEANINGFUL DISTINCTION BETWEEN "PRIMARY" AND "SECONDARY" LIABILITY UNDER THE STATUTE.

This Court's ruling in *Central Bank* maintained a principled distinction between primary and secondary liability under Section 10(b). *See* 114 S. Ct. at 1455. That distinction is not a judicial creation, but rather was carefully drawn by Congress when it required, for proof of a primary violation, that the defendant "*use or employ*" a fraud "*in connection with the purchase or sale of any security*." Unlike Section 18, which merely requires that a false statement be *made*, Section 10(b) further requires that the false statement be *used* by a defendant *in connection with* a particular securities trade. The "use or employ . . . in connection with" requirement, therefore, necessarily operates as a *limitation* on Section 10(b) liability. This requirement must be satisfied independently of whether a false or "deceptive" statement within the meaning of Section 10(b) has been made.

The policy-based *Texas Gulf* approach followed below improperly focuses solely on the *making* of a false statement and its potential *effect* on investors (a proper part of the Section 18 inquiry), rather than on whether the defendant "*use*[*d*] *or employ*[*ed*]" the statement "*in connection with*" a securities trade (a required part of the Section 10(b) inquiry). As a result, the Ninth Circuit's ruling sweeps conduct that, by any fair measure, is *secondary* to a securities transaction within the scope of *primary* liability under Section 10(b).

A. The Independent Auditor's Role Is Secondary To That Of The Client.

The only alleged misconduct by Ernst & Young is its rendering of an allegedly false audit report to CPC, which CPC subsequently included in its routine annual Form 10-K filing. When accountants act as independent auditors, they engage in conduct that is classically "secondary" in nature. The financial statements upon which auditors report are prepared by the client, not by the auditors. The client has direct control over and assumes responsibility for their contents. Moreover, the client—not the auditor—is responsible for complying with the disclosures required under the federal securities laws and rules. The client decides what information will or will not be made public, and the contents of the reports filed with the SEC. The independent auditor's role is limited to preparing the audit report and providing it to the client.[7]

The California Supreme Court captured the essence of the independent audit function in *Bily v. Arthur Young & Co.*, 834 P.2d 745 (Cal. 1992):

> An auditor is a watchdog, not a bloodhound. As a matter of commercial reality, audits are performed in a client-controlled environment. The client typically prepares its own financial statements; it has *direct control over and assumes primary responsibility* for their contents. * * * Thus, regardless of the efforts of the auditor, the client retains *effective primary control* of the financial reporting process.

Id. at 762 (emphasis added); *see also Codification of Auditing Standards and Procedures, Statement on Audit-*

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[7] The audit report states that the auditor has examined the client's financial statements by applying certain test procedures and based on those procedures has formed an opinion as to whether the client's financial statements are fairly reflected in all material respects when taken as a whole.

ing Standards No. 1, § 110.02 (AICPA 1994) ("financial statements are management's responsibility").

Independent auditors also receive a set fee for their services and can have no financial stake in securities transactions conducted by the client or third parties. Regulations imposed both by the SEC and the Institute restrict an independent auditor from having a financial interest in the client. *See* 17 C.F.R. § 210.2-01(b) (1996); *Codification of Auditing Standards and Procedures, Statement on Auditing Standards No. 1*, § 220 (AICPA 1994).

The role of the independent auditor simply cannot be squared with the conduct described by Congress in Section 10(b). It strains the statutory text too far to say—particularly after *Central Bank*—that, by issuing an audit report to the client, the *auditor* has "used or employed" the report "in connection with" a purchase or sale of securities. Whatever uses the client makes of the report, the auditor's role remains necessarily secondary.

B. The Independent Auditor's Liability Properly Lies Under Section 18.

An independent auditor still may be liable under the federal securities laws. As shown, Section 18 imposes civil liability on accountants and others who make false statements in disclosure documents that affect the price of a stock. Section 18 was enacted contemporaneously with Congress's creation of the audit reporting requirements, and contains the express reliance limitation.

Giving proper effect to the plain meaning of the "use or employ . . . in connection with" requirement, therefore, not only preserves a meaningful distinction between "primary" and "secondary" liability under Section 10(b), but also harmonizes the implied Section 10(b) and express Section 18 actions.

III. THE QUESTIONS PRESENTED BY THE PETITION WARRANT THE IMMEDIATE ATTENTION OF THIS COURT.

The decision below, if allowed to stand, will expose accountants to potential Section 10(b) liability every time they render an audit report to a publicly traded client. Because the SEC requires that audit reports be included in Form 10-Ks and other routine disclosure documents, strike-suit plaintiffs will have little difficulty continuing to ensnare perceived "deep pocket" accountants in Section 10(b) cases at will—as they did under the aiding and abetting concept—simply by alleging some problem with the audit report.[8] Congress clearly did not intend for this result when it created the express right of action under Section 18 contemporaneously with the regulatory reporting requirements involving accountants. Nor could this Court have intended such a result when it preserved a meaningful distinction between "primary" and "secondary" liability under Section 10(b) in its *Central Bank* decision.

The fact that accountants ultimately may prevail in defending against Section 10(b) claims offers little comfort given the actual experience of the accounting profession. As this Court has noted, Section 10(b) litigation poses a vexatiousness different in degree and kind from

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[8] Indeed, by nullifying the actual reliance requirement of Section 18, the decision below poses particular concern to the accounting profession given the fact that the majority of lower courts have held that allegations of mere recklessness satisfy the *scienter* requirement of Section 10(b). *See, e.g., Kehr v. Smith Barney, Harris Upham & Co.*, 736 F.2d 1283, 1286 (9th Cir. 1984); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 46 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978). The ability to allege nothing more than that an auditor acted "recklessly" in conducting an audit, coupled with the broad *Texas Gulf* foreseeability approach to the "use or employ . . . in connection with" requirement, will allow strike-suit plaintiffs to plead even garden variety negligence claims as Section 10(b) claims against accountants who audit publicly traded companies.

general litigation. *Central Bank*, 114 S. Ct. at 1454 (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975)). The risks of expansive liability and crippling defense costs often compel accountants to settle even meritless Section 10(b) claims. *Id.* This Court has recognized that such overly broad liability under Section 10(b) can have adverse "ripple effects" that impede the provision of professional services to market participants, reduce the level and quality of financial reporting, and ultimately injure the very investing public Congress sought to protect. *Id.*

The questions raised by the Petition are critically important to the accounting profession and others, and warrant the immediate attention of this Court.

CONCLUSION

For the foregoing reasons, the Institute respectfully urges this Court to grant the Petition.

Respectfully submitted,

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